Economcis focus: Two tales of trade

INDEX TERMS **Economics focuses|wage gaps and trade;Wages and salaries|earnings gap and trade, economics focus;Foreign trade|effect on wage gap, economics focus**
DATE **19-Jul-97**
WORDS **1030**

Broadly, economists agree that trade has had little effect on the wages of unskilled workers in rich countries. They disagree about why

Two tales of trade

Broadly, economists agree that trade has had little effect on the wages of unskilled workers in rich countries. They disagree about why THERE is probably never a good time to be unskilled and poorly educated, but the late 20th century has been particularly harsh for those worst-equipped to get a job. In America and Britain, the gap between the earnings of university graduates and the less educated has been rising sharply for several years. In other wealthy countries with less flexible labour markets, the rise in wage inequality has not been so marked; but the least educated are still less likely, in relation to the best, to be in work than they were a decade ago.

Many people see the hand of freer trade, especially trade with developing countries, in all this. It is a common fear that jobs in rich countries are under threat from developing countries where wages are lower. Less-educated workers are thought to bear the brunt of this competition, and so are falling further behind the well-lettered.

The widening gap is a fact. Yet a huge amount of economic research has produced scant evidence that trade has had much to do with it. Instead, the wider gap seems to be due mostly to technological advance, which has boosted the productivity and wages mainly of the better educated while leaving the least educated lagging. But, though economists agree that trade's impact has been slight, they disagree about why. Roughly speaking, according to a recent review of the literature by Matthew Slaughter of Dartmouth College and Phillip Swagel of the IMF *, the methodological dispute pits economists who specialise in trade against those who work on labour markets.

The trade economists argue that trade affects wages through the prices of imports and exports. Suppose that a rich country, which has a relatively large proportion of well-educated workers, starts trading with a poor country that has plenty of uneducated labour but relatively few graduates. Then both countries will specialise according to their relative strengths—the rich country in making things that use more brainpower; the poor country in industries that use relatively less. Both countries are made better off. But the least educated workers in the rich country may lose out. Why? Because the relative prices of the goods they make are forced down by import competition, and this pushes down their wages.

The labour economists, however, argue that trade affects the labour market mainly through the volume of trade, not through prices. The idea is that by importing goods, a country is essentially importing the labour used to make those goods. Imports of goods made by low-skilled workers thus have the same effect as an increase in the supply of low-skilled workers: they drive down wages. Thus changes in a country's imports and exports can be used to estimate the effect on the demand for local workers. From that, the impact on wages is worked out.

Each side finds fault with the other's approach. Trade theorists dislike the labour economists' method because, they say, it is not just the number of toys shipped across the border that affects wages in the toy industry. The mere threat of foreign competition may be enough to force down prices and wages, whether or not imports are large. Nor, they say, is it right to assume that imports displace goods made by local workers one-for-one: if America made all its toys at home rather than importing them from China, the price would be higher, and hence fewer toys would be sold.

The labour economists retort that the trade economists' price-based studies also have flaws. Data on the prices of traded goods are often inadequate. And these studies may fail to distinguish trade from other factors that affect wages. As an economy grows and its people get richer, they spend a smaller share of their income on cheap clothes and more on fast cars. That would push down the wages of a textile worker compared with those of a design graduate; but it would have nothing directly to do with trade. Ascribing all changes in the price of traded goods to freer trade is thus misleading.

The skirmishes ahead

Despite these differing approaches, it is remarkable that both camps broadly agree that trade has done little to increase inequality, and that technology has played a far bigger part. Even so, there is still plenty of research to be done, and plenty to argue about.

Both schools have struggled to disentangle the effects of trade from those of technology. Faced with increased competition from abroad, firms can cut costs by replacing workers with machines: trade and technology then go hand in hand. Trade's impact is also hard to isolate when considering changes in the composition of an industry's workforce. Clothing firms in rich countries, for instance, now employ a higher proportion of designers and a lower proportion of sewing-machine operators than they used to. In part, this is a response to foreign competition, but it is also a reaction to changing tastes, and to the fact that production processes are easier to automate than design or marketing. But how much of each?

Another question is whether price trends are actually consistent with increasing trade pressure on low-skilled workers. There is a running argument among economists about whether prices in low-skill industries have fallen compared with those in industries using relatively more high-skilled workers. If not, then trade would seem to have had little impact on inequality. The evidence is mixed. In its recent *Employment Outlook*, the OECD concludes that in 18 member countries relative prices of low-skill products did fall during the 1980s. But in America, the focus of most of the research in this field, some studies point one way, others the opposite.

Whatever further research throws up, it seems unlikely to overturn the current consensus: that greater trade has contributed a little to wage inequality, but not much. That leaves both trade experts and labour-market scholars in agreement that restricting imports would be a clumsy and ineffective way to make low-wage workers better off.

The Effect of Globalisation on Wages in the Advanced Economies. IMF working paper. April 1997.